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Malaysian débâcle: whose fault?

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Except for a large current-account deficit, Malaysia's macroeconomic fundamentals were in order before the crisis beginning in mid-1997. The current-account deficit—covered by short-term capital inflows into Malaysia's emerging stock market as well as private sector short-term US dollar borrowing from foreign banks—was deemed acceptable with the 8+% export-led growth achieved during the period 1988–96. The virtual pegging of the Malaysian ringgit and other South-east Asian currencies to the US dollar from the mid-1980s enhanced export competitiveness until the yen began to depreciate from mid-1995. This eventually disastrous exchange rate policy was favoured by the politically influential financial interests which have dominated the South-east Asian economies, whose manufacturing sectors have been dominated by foreign direct investment. The collapse of the Thai baht and the contagion effect exacerbated by herd behaviour resulted in the collapse of the asset price bubble that had been encouraged by financial liberalisation and sustained by the very high investment rate which exceeded the Malaysian high savings rate. Poor policy responses by the Malaysian authorities as well as a defiantly dissenting executive have undermined the confidence necessary for recovery. Contractionary policies—demanded by financial markets and the IMF, and introduced from the end of 1997—have brought the Malaysian economy into recession in the first half of 1998 after over 7% growth in 1997.

In the immediate aftermath of the outbreak of the East Asian financial crisis in July 1997, the first generation of currency crisis theories—which had focused on public sector debt related to fiscal deficits—were very soon seen as irrelevant to South-east Asia, since most of the affected governments had consistently maintained budgetary surpluses in recent years. Many observers immediately assumed that the crises were due to poor macro-economic management, as suggested by the second generation of theories seeking to explain currency crises.

However, it also soon became clear that all the governments affected had been maintaining decent macroeconomic balances except for balance-of-payments current-account deficits, especially in the case of Malaysia and Thailand. These had been bridged by massive capital inflows, mostly of a short-term nature, in the form of portfolio investments and also foreign borrowings. With the debt—including foreign borrowings—mainly involving the private sector, and with continued high savings and growth rates as well as low consumer price inflation despite huge financial inflows, the monetary and financial policies in the region had been largely encouraged by the international financial community.

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Once it was clear that the region's macroeconomic balances were not seriously awry, various commentators, including US Federal Reserve Board chairman Alan Greenspan, began to focus on alleged cronyism and its supposed consequences as the new explanation for the crises. Nebulous catch-all terms, such as cronyism and Asian values, as well as business practices seemed to provide ready-made explanations for the crises. Differences in organisations, relations, practices and norms—which had previously been credited with the East Asian miracle by some commentators—were now condemned as the sources of the financial débâcle. Popular versions of the political economy of rent seeking are now readily invoked and deployed in the post-crisis discourse as if to explain all, while, in fact, often explaining nothing.

Despite ongoing debates about the significance of macroeconomic fundamentals and crony capitalism in contributing to the East Asian economic crises since mid-1997, there is now little disagreement that they began as currency and financial crises. It will be argued here that the currency and financial crises in Malaysia became a crisis of the 'real economy' mainly as a result of the government's policy responses, and partly as a result of financial market demands and the IMF. Related work (Montes 1998; Jomo 1998) shows that the crises have been caused by the undermining of previous systems of international and national economic governance due to deregulation and other developments associated with financial liberalisation and globalisation. Thus, the erosion of effective financial governance at both international and national levels created conditions that led to the crises.

This analysis of the crisis in Malaysia since mid-1997 is also based on recognition of major structural and systemic differences among the eight high-performing Asian economies (HPAEs) studied by the World Bank (1993), namely Japan, South Korea, Taiwan, Hong Kong, Singapore, Malaysia, Thailand and Indonesia. The last three may be distinguished as second-tier or second-generation South-east Asian newly industrialising countries (NICs), with characteristics quite different from the others, and, of course, even among themselves. Industrial policy or selective state intervention has been of much poorer quality and less effective in these economies for various reasons; instead, there has been much other state intervention motivated by other (non-developmental) considerations, especially in Malaysia and Indonesia (Jomo *et al.*, 1997).

Such interventions—now often cited as evidence of 'crony capitalism'—bear some of the responsibility for the vulnerability of the second-tier South-east Asian NICs to the factors that precipitated the financial crisis in the region in mid-1997. More importantly, such interests have influenced government policy responses in ways that have exacerbated the crisis. In other words, while crony capitalism does not really explain the origins of the crisis, except in so far as crony financial interests were responsible for the financial policies from the mid-1990s which led to the crisis, it has certainly exacerbated the crisis in Malaysia.

This contribution to the debate will begin by outlining recent financial developments in Malaysia before considering the broader macroeconomic situation. It will show how financial interests and financial liberalisation led to the overvalued currency and its adverse macroeconomic and developmental consequences. It will then review the official policy responses to the currency and financial crises, and show how they have contributed to the crisis of the real economy. Although Malaysia has not been subject to IMF conditionalities in return for receiving credit facilities, since December 1997 it has adopted similar contractionary policies. Other policy biases in favour of politically influential 'cronies' have also exacerbated the situation, undermining the efforts to restore confidence which are considered so crucial to recovery.

Recent financial developments before the crisis

The turn of the decade saw two important developments with enormous implications for the future of Malaysia's financial system. In 1989, the Banking and Financial Institutions Act (BAFIA) was passed by Parliament, with vast implications for governance of the financial system. Soon after, the Kuala Lumpur Stock Exchange (KLSE) broke off from its Siamese twin, the Stock Exchange of Singapore (SES), paving the way for its subsequent rapid expansion. In 1992, the Securities Act was passed to enable the establishment of a new Securities Commission (SC), which took over the role of the Capital Issues Committee (CIC), previously controlled by the central bank, Bank Negara Malaysia (BNM).

Despite the relatively recent rapid growth of securities markets in Malaysia (first established in the early 1960s by MIDF, or Malaysian Industrial Development Finance), the banking system remains the main source of funds raised by the private sector, in both absolute and relative terms. Being a former British colony and greatly influenced by financial trends in the US and UK since independence, the Malaysian financial system has exhibited many features of the 'Anglo-Saxon model', restricting banking activities to accepting deposits, granting loans and other specified activities. Banks in Malaysia are kept at arm's length from involvement in corporate governance and management. Shares held by a commercial bank in manufacturing companies should not exceed 10% of the paid-up capital and reserves or 5% of a foreign bank's net working funds, whichever is lower. Malaysian banks also tend to be conservative, mainly extending loans on the basis of collateral, rather than project viability. 'These policies…impose on industry a similarly cautious and short-term view of investment, profitability and profit allocation and inhibit long-term or high-risk industrial investment' (Hing, 1987, p. 422).

The first half of the 1980s saw many abuses by directors and staff of banks and finance companies in lending operations. Some major Bumiputera-controlled conglomerates[1] emerged at this time, usually with the patronage of powerful politicians, e.g., in the form of soft loans from state-owned banks and the award of major projects and licences as well as other lucrative business opportunities. The ownership of financial institutions as well as top corporations by the government and by state-owned enterprises and, later, the privatisation of some of them served to encourage such developments. Huge loans could be obtained without going through proper procedures, and were often given for speculative get-rich-quick schemes, rather than for productive investments. As such, other national developmentalist priorities, e.g., entailing industrial policy, were neglected.

Meanwhile, many major corporate groups controlled by non-Bumiputeras[2] have also grown as a result of political patronage, arising from close ties with powerful, often Malay politicians (Gomez and Jomo, 1997). During the height of implementation of the ethnic redistributive New Economic Policy (NEP), many Chinese capitalists minimised their vulnerability to long-term risks by moving capital abroad, mainly from the mid-1970s

[1] Bumiputera refers to the indigenes of Malaysia, mainly the Muslim Malays of Peninsular Malaysia.

[2] Non-Bumiputeras refer to those not considered indigenous to Malaysia, mainly ethnic Chinese and Indians.

until the late 1980s (Jomo, 1990). Within the country, many preferred short-term investments in construction, commercial property and residential housing at the expense of more productive investments, e.g., in manufacturing. In addition, Malaysian banks have little incentive to operate as long-term agents (because of the lower franchise value for banks) as the government has done little to ensure that the banking system effectively finances productive investments, especially in potentially export-oriented manufacturing (Chin and Jomo, 1996).

Emphasis on loan security has encouraged loans to the property sector for share purchases and for consumption rather than for production. The share of bank credit to the property sector rose from 21·6% in 1977 to 35·9% in 1988 following the liberalisation of interest rates, which coincided with a property boom. This huge increase contrasted with the modest increase in the relative importance of building and construction in GDP, and reflected the greater profitability of property investments owing to rapid price appreciation. Loans by the banking system for consumption credit also rose together with loans for the purchase of stocks and shares. As a result, the share of credit to the manufacturing sector declined during this period despite a sharp increase in manufacturing's share of GDP.

A BNM Survey of Private Investment in Malaysia found that this reduction in the share of bank credit to the manufacturing sector caused firms to rely increasingly on internally generated funds. On average, the surveyed firms financed 52% to 66% of their capital expenditure from internally generated funds in the period 1986–90. Bank financing only accounted for between 10% to 14% of total financing. Although banks still provided a larger share of external finance than the capital market (ranging from 1% to 8%), this probably reflected the less developed state of the capital market *vis-à-vis* the banking system then. Company size was also found to be an important determinant of access to credit, with larger companies enjoying lower credit costs on average. This could be due to the less stringent requirements imposed by financial institutions on bigger companies with better track records and reputations (see Zainal *et al.*, 1994, p. 313). Such 'discrimination' was more pronounced during the recessionary years of 1985–86, when the average cost of credit for large companies was almost 11% lower than for small and medium-sized enterprises.

The absence of any incentive for Malaysian bankers to favour long-term lending for productive investments is one reason for the limited development of Malaysian manufacturing capabilities, especially in non-resource-based export-oriented industries (which are instead dominated by foreign investors). Export-oriented manufacturing only accounts for a very small percentage of total outstanding loans extended by commercial banks. With the exception of export credit and some relatively minor financial institutions, there is little other evidence of financial policy serving as an important tool of industrial policy in Malaysia (Chin and Jomo, 1996). Only slightly over a quarter of Malaysian commercial bank lending goes to manufacturing, agriculture, mining and other productive activities; the percentage is likely to be even smaller with foreign borrowings, most of which have been collateralised with assets such as real property and stocks. Hence, despite considerable government intervention in the financial sector, more than 70% of bank lending in Malaysia has not been for productive investments in manufacturing, agriculture and mining, but for other purposes, especially property and share purchases and consumption credit (Chin and Jomo, 1996).

In the mid-1990s, well before the crisis, the BNM began trying to consolidate Malaysian banks, in anticipation of further financial liberalisation. A new two-tier regulatory system was introduced in December 1994. The new system sought to provide incentives for smaller banks to recapitalise and merge. To qualify for tier-one status, banks must have an equity base of at least RM500 million. Tier-one banks have the exclusive privilege of handling certain lucrative kinds of transaction denied to other banks, such as opening foreign currency accounts.

Hence, while financial restraint exists in Malaysia, it has primarily sought to ensure bank profitability, especially with increasing Bumiputera dominance of the Malaysian banking system from the 1970s. Banks in Malaysia have been heavily used by the state for the wealth redistribution policies of the New Economic Policy (NEP). As Bumiputeras advanced their interests in the financial sector, rents were created by limiting competition in some areas, especially from foreign banks. However, this was not complemented by other policies to restrict wasteful competition in the banking sector that would erode these rents. Instead, the lucrative banking margins have fostered wasteful competition, e.g., with too many bank branches competing for limited business in particular areas resulting in a socially wasteful duplication of services, which undermines the likelihood of scale economies in the provision of banking services (Chin and Jomo, 1996).

The almost singular preoccupation with inter-ethnic economic redistribution has compromised the purpose, nature and quality of state intervention generally and of financial restraint in particular. Though utilised to support inter-ethnic economic redistribution and other related public policies, financial restraint in Malaysia has not been much used to favour long-term productive investments, especially in non-resource-based export-oriented manufacturing, which continues to be dominated by foreign direct investment (FDI). As a result, an alternative agenda for financial restraint more conducive to late industrialisation efforts has been thwarted.

However, it is not this system of financial restraint in itself, despite all its problems, that has caused the recent financial problems culminating in the crisis. Rather, the roots of the crisis can be traced to partial and improperly sequenced liberalisation of the Malaysian financial system; after all, 'in a deregulated, liberal environment, banks are prone to speculate or lend excessively in areas such as in real estate, stocks or commodities' (Park, 1994, p. 20). Malaysia should have been more prudent in liberalising and deregulating the domestic financial sector. Prudent regulation by the government is necessary to help maintain a balance between the competitive efficiency of markets and the security of the banking system (Park, 1994, p. 21; Chowdhury and Islam, 1993, p. 144). Appropriately sequenced deregulation as well as continued regulation of the capital account to constrain exit might have been able to mitigate some of the worst excesses which have contributed to the recent financial crises in Malaysia and South-east Asia.

In recent years, promotion of stock markets all over the world by the International Finance Corporation (IFC), a World Bank subsidiary, has resulted in the growing significance of equity finance and stock markets in the South-east Asian region, especially in Malaysia, with its British colonial heritage. As noted earlier, the split between the Kuala Lumpur Stock Exchange and the Stock Exchange of Singapore at the end of the 1980s gave momentum to the growth of the stock market in Malaysia. The 1992 passage of the Securities Act and the subsequent establishment of the Securities Commission (SC) gave further impetus to stock-market growth in Malaysia, with the SC taking over the role of the Capital Issues Committee (CIC) previously under the central bank's jurisdiction, and thus reducing the latter's role in overall financial management.

The successful promotion of the stock market in recent years has been accompanied by significant financial disintermediation from the banking system to the securities markets, particularly in the bull-run years of the early 1990s, though corporate savings continue to account for much corporate financing. Imminent financial liberalisation is expected to exacerbate most of these trends, and to reduce further the financial sector's support of productive long-term investments. Hence, the stock-market boom in recent years does not seem to have raised funds for productive investment more effectively. In June 1995, the finance minister announced a package of incentives to attract foreign fund managers to Malaysia, thus further liberalising the capital market for foreign financial institutions. Inevitably, this made the national economy much more vulnerable to both international macroeconomic fluctuations as well as capital flight, and rendered the tasks of exchange rate management and controlling inflation much more difficult.

It has been estimated by stock-market analysts that, by mid-1997, about a quarter of the stock in the Kuala Lumpur Stock Exchange was in foreign hands, another quarter was held by Malaysian institutions, with the rest constituting the 'retail trade' of price-takers. While most Malaysian shareholders only operate within the Malaysian stock market, foreign institutional investors see the Malaysian market as only one of many different types of financial market in a global financial system including many national markets, i.e., the global financial system is hardly a market of equals. Although always in the minority, foreign investment institutions 'made' the stock markets in the region, shifting their assets among securities markets as well as among different types of financial investment options all over the world. In the face of limited transparency, the regional nature of their presence, the nature of fund managers' incentives and remuneration and the short-termism of their investment horizons, foreign financial institutions were much more prone to herd behaviour and contributed most to the regional spread of contagion. To quote Mansor (1994, p. 10): 'Although only about 20% of daily market activity has been attributed to foreign funds, the influence of foreign funds is more than their share of the volume of activity, as they are generally considered market leaders. Their presence is crucial to lending credibility and international standing, which are important elements in raising future capital, locally and overseas.'

Stock-exchange listing has often been a means to access more bank borrowings on better terms. The establishment of the Labuan International Offshore Financial Centre (IOFC) in Malaysia in 1993 facilitated greater access on better terms to international funds. Increased competition among 'debt-pushing' Japanese and continental European banks (who appreciated the higher interest rates available for dollarised short-term loans to the region) eased access to foreign funds. These and other reforms, as well as the growth of 'private banking' and 'relationship banking' in the region, also weakened the scope and efficacy of national-level prudential regulation.[1]

From currency to economic crisis

The Malaysian economic boom from the late 1980s had been helped by the significant depreciation of the ringgit against the US dollar from late 1985. Meanwhile, the Japanese yen and then the Korean won, the new Taiwanese dollar and the Singapore dollar, all appreciated against the US dollar and, hence, even more against the ringgit. Labour shortages and the 1988 withdrawal of privileges under the General System of Preferences

[1] After the 1992 débâcle, when Bank Negara Malaysia lost tens of billions of ringgit after sterling devalued under pressure from hedge fund managers associated with George Soros, the central bank's prestige was greatly diminished and its powers reduced.

(GSP) from the first-tier East Asian newly industrialising economies of South Korea, Taiwan, Hong Kong and Singapore encouraged the relocation abroad of production facilities from these NIEs. Meanwhile, reforms, selective deregulation and other new incentives made relocation in South-east Asia as well as China more attractive. Malaysia's resource wealth and relatively cheap labour sustained production for export of agricultural, forest, mineral and, more recently, manufactured products. Much of the wealth generated was captured by business cronies of those in power, who in turn contributed to growth by re-investing in the 'protected' domestic economy, mainly in import-substituting industries, commerce, services, property, privatised utilities and infrastructure.

However, the recent crisis suggests that Malaysia's economic boom of the last decade was built on some shaky and unsustainable foundations. Recent growth was increasingly heavily reliant on foreign resources, both capital and labour. It was becoming quite clear that Malaysia's future economic progress could no longer be secured by continued reliance on its previous economic strategy emphasising cheap labour and other production costs. Yet, limited and inappropriate investments in human resources continued to hold back the development of greater industrial and technological capabilities in the country, as elsewhere in the region (Jomo and Felker, 1999; Jomo, Felker and Rasiah, 1999). Export-led growth since the late 1980s was thus followed by a construction and property boom, fuelled by financial interests favouring such 'short-termist' investments—involving loans with tangible asset collateral which bankers like—over more productive, but also apparently more risky investments in manufacturing and agriculture. The exaggerated expansion of investment in such 'non-tradables' also exacerbated current-account trade deficits.

Although high growth was sustained for almost a decade, during most of which fiscal balances were in order, monetary expansion was not excessive and inflation was generally under control, some other indices have been awry. Foreign savings supplemented the already high domestic savings rates in the region to accelerate further the rate of capital accumulation, albeit in increasingly unproductive activities owing to the foreign domination of most internationally competitive industries in the region. Malaysia's savings–investment gap, which was 5% of GNP in 1997, lay behind the current-account deficit, which has exceeded RM12 billion since 1994. Before the 1990s, the gap had been bridged by foreign direct investment. But high FDI and foreign debt have, in turn, caused growing investment income outflows abroad. In recent years especially, the current-account deficit was increasingly covered by short-term capital inflows. Much portfolio investment went into the stock market in 1993 and again from 1995 until mid-1997, with disastrous consequences following their hasty exit. Many recent confidence-restoring measures seek to induce such short-term inflows once again, but they obviously cannot be relied upon to address the underlying problem of the persistent current-account deficit in the medium to long term.

Companies and banks in Malaysia were also borrowing heavily from abroad, thus increasing capital inflows. According to the central bank,[1] commercial banks' net foreign liabilities increased from RM10·3bn at the end of 1995 to RM25·2bn in June 1997, while their net external reserves position deteriorated from –RM5·3bn to –RM17·7bn over the same 18-month period! Fortunately, a lower proportion of foreign borrowings was of

[1] With financial liberalisation, it is likely that official measures of such flows underestimate the actual extent of these borrowings.

a short-term nature[1] compared to Thailand and Indonesia, and a greater proportion was hedged, owing to the lower costs of hedging for Malaysian borrowers. One reliable estimate of the foreign borrowings of almost 90 of Malaysia's largest listed companies estimates their total borrowings at around RM35bn, with the three largest borrowers alone accounting for three-quarters of this corporate foreign debt. Malaysia's medium and long-term debt as a percentage of net external reserves rose dramatically over two and a half years from 102% at the end of 1994 to 176% in June 1997, after declining since the aftermath of the mid-1980s crisis (Jomo, 1990).

Capital inflows—to the stock market as well as through bank borrowings—helped bridge current-account deficits due to the growing proportion of non-tradables being produced in Malaysia, much of which involved (infrastructure as well as property) construction activity. These flows were 'sterilised' to minimise consumer price inflation, and instead fuelled asset price inflation, mainly involving property and share prices.[2] Consequently, by mid-1997, several related economic problems had emerged from the rapid growth of the last decade.

Despite the central bank's claim that the ringgit has been pegged to a basket of the currencies of Malaysia's major trading partners, for all intents and purposes it has been virtually pegged to the US dollar for many years. Such quasi-pegging offered certain advantages including the semblance of stability—and low inflation—so much desired by the financial interests. The 1990 and then the 1994 devaluations of China's renminbi put greater competitive pressure on the emerging second-tier or second-generation South-east Asian NICs, including Malaysia.

The problem was exacerbated by the failure to 'progress' more rapidly to higher value-added production, mainly owing to inadequate or misallocated public investments in education and training as well as limited indigenous internationally competitive industrial capabilities. As the US dollar strengthened with the US economy, especially against the Japanese yen from mid-1995, the ringgit and other regional currencies followed suit, adversely affecting South-east Asian export competitiveness. This reflected the political weakness—especially in terms of influencing economic policy-making—of export manufacturer interests in Malaysia—where almost all internationally competitive non-resource-based industrial capability is foreign-owned—compared to financial interests.

With exports and growth more generally affected most adversely in Thailand, and the property market, construction activity, stock market and financial institutions also under strain, Thailand was the choice target in the region for a currency attack. Several currency attacks from late 1996 severely depleted the Bank of Thailand's reserves, forcing it to let the baht float from 2 July 1997. With the baht down, currency speculators turned their sights on the other economies in the region that had maintained similarly unsustainable US dollar quasi-pegs for their currencies. Both the Indonesian and Filipino monetary authorities gave up defending their currencies after very brief but nonetheless costly

[1] According to the Bank of International Settlements (BIS) (*Asian Wall Street Journal*, 6 January 1998), 56% of Malaysian foreign borrowings from commercial banks were short term in nature. According to the Malaysian central bank, however, only 30% of all foreign borrowings were short term in nature, with another 9% due in the next year, i.e., 39% in all.

[2] Some commentators claim that the resultant property price bubble has its roots in Japanese-type or more generically East Asian culture, norms and relationships which compromise relations between the state and the private sector as well as among businesses, invariably involving welfare-reducing, if not downright debilitating rent-seeking behaviour. In so far as such relations are believed to exclude outsiders, their elimination is believed to contribute to levelling the playing field and bringing about an inevitable convergence towards supposedly Anglo-American-style arms-length market relations. See Chang (1994) for a critique of this view.

defence attempts. Only the Malaysian central bank put up a more spirited—and expensive—defence of its currency. In mid-July, the ringgit rose to RM2·47 against the US dollar from RM2·53, before the authorities finally gave up ringgit support operations after hefty losses of several billion US dollars.

There was widespread consensus that the ringgit had become overvalued by the 'quasi-peg' against the US dollar as the American economy and dollar had strengthened significantly in recent years.[1] Hence, the ringgit was expected to depreciate to around RM2·7–3·0 against the dollar, the supposed 'equilibrium' exchange rate based on calculations taking account of purchasing power parity, etc. However, since mid-July 1997, the Malaysian ringgit has fallen precipitously, reaching RM4·88 to the US dollar in early January 1998, its lowest level ever; this represented a collapse by almost half within less than half a year from a high of RM2·47 in July 1997. The stock market has fallen more severely, with the main Kuala Lumpur Stock Exchange (KLSE) Composite Index (KLCI) dropping to less than 500 in January 1998 from over 1,300 in the first quarter of 1997.

This sudden and massive collapse of the ringgit—politely referred to in the financial community as 'overshooting'—by about two ringgit against the dollar, much more than the anticipated 'correction' of RM2·7–3·0, raises serious questions about the very nature of the international monetary system. Other international, regional and domestic speculators also contributed to the collapse by reacting in their own self-interest to perceived and anticipated market trends. As investors scrambled to get out of positions in ringgit and the other regional currencies, the currencies fell further, and, with them, the stock and other markets. With financial liberalisation, fund managers have an almost infinite variety of investment options to choose from and can move their funds much more easily than before, especially with the minimal exit restrictions Malaysia and the other countries in the region prided themselves on. The operations and magnitude of hedge funds have also exacerbated these phenomena, with disastrous cumulative consequences.

Policy responses: deepening the crisis

The ringgit's collapse has been portrayed by Malaysian Prime Minister Mahathir as exclusively due to speculative attacks on South-east Asian currencies. In a study published in mid-April 1998, the IMF acknowledges that currency speculation precipitated the collapse of the baht, but denies the role of currency speculation in the collapse of the other East Asian currencies. While currency speculation *per se* may not have brought down the other currencies, the contagion effect undoubtedly contributed to the collapse of the other currencies in the region not protected by the large reserves held by Japan, China, Taiwan, Hong Kong and Singapore. Thus, contagion—exacerbated by the herd-like panicky investment decisions of foreign portfolio investors who perceived the region as much more similar and integrated than it actually is (e.g., in terms of trade links)—quickly snowballed into massive capital flight.

The ringgit probably fell much further than might otherwise have been the case owing to international market reactions to Mahathir's various dissenting statements, including his tough speech in Hong Kong on 20 September 1997, at a seminar before the joint World Bank–IMF annual meeting. Arguing that 'currency trading is unnecessary,

[1] For example, the yen fell from less than 80¥ to the US$ in mid-1995 to over 120¥ by mid-1997, while the Deutschmark had floated against the US dollar before mid-1997.

unproductive and immoral', Mahathir suggested that it should be 'stopped' and 'made illegal' and, most damagingly, seemed to threaten a possible unilateral ban on foreign exchange purchases unrelated to imports by the Malaysian authorities (which never happened). Before his Hong Kong speech, Mahathir had railed against George Soros (calling him a 'moron') and international speculators for weeks, even suggesting dark Western conspiracies to undermine the East Asian achievement. Mahathir's remarks continued to undermine confidence and to exacerbate the situation until he was finally reined in by regional government leaders and, perhaps, his cabinet colleagues.

The Prime Minister's partly—but not entirely—ill-founded attacks reinforced the impression of official denial, with blame for the crisis attributed abroad. The fact that there was some basis for his rantings was hardly enough to salvage his reputation in the face of an increasingly hostile Western media. Thus, until Suharto's illness (in December 1997) and subsequent recalcitrant behaviour (in the eyes of the international financial community) in 1998, Mahathir was demonised as the regional 'bad boy'. Meanwhile, other governments in the region went 'cap in hand' to the IMF and Western governments in desperate efforts to restore confidence and to secure funds to service the fast-growing foreign debt liabilities, despite the fact that they were privately held.

Other official Malaysian policy responses did not help. The authorities' designation of the supposedly indicative top 100 KLCI share counters—by requiring actual presentation of scrip at the moment of transaction (rather than later, as was the normal practice), ostensibly to check 'short selling', which was exacerbating the stock-market collapse—also adversely affected liquidity, causing the stock market to fall further. The government's threat to use repressive measures against commentators making unfavourable reports about the Malaysian economy strengthened the impression that the government had much to hide from public scrutiny. The announcement of the 1998 Malaysian Budget was seen by 'the market', i.e., mainly foreign financial interests, as only the latest in a series of Malaysian government policy measures tantamount to 'denial' of the gravity of the crisis and its ostensible causes.

A post-Cabinet meeting announcement on 3 September 1997 of the creation of a special RM60 billion fund for selected Malaysians was understandably seen as a bail-out facility designed to save 'cronies' from disaster. Although the fund has not been institutionalised, and many government officials deny its existence, public funds, mainly in the Employees Provident Fund (EPF) and the Petronas, have been increasingly deployed to bail out some of the most politically well-connected and influential, including Mahathir's eldest son, his party cooperative (KUB) and the country's largest conglomerate (Renong), previously controlled by Mahathir's party and now believed to be ultimately controlled by Mahathir and his confidante, former Finance Minister Daim. The protracted UEM–Renong saga was probably most damaging. This 'bail-out'—to the tune of RM2·34 billion—gravely undermined public confidence in the Malaysian investment environment as stock-market rules were bent at the expense of minority shareholders.

The situation has been worsened by the perception that Mahathir and Daim have taken over economic policy-making from Deputy Prime Minister Anwar, who has endeared himself to the international financial community. The emergence of this troika has caused ambiguity about who is really in charge and what to expect. Some of the measures introduced by the Finance Ministry and the central bank since early December 1997 and in late March 1998 have also been perceived as pre-empting the likely role and impact of the National Economic Action Council (NEAC), chaired by the prime minister with Daim as executive director.

The possibility of IMF intervention in Malaysia enjoys a certain mystique as various groups have rather different perceptions of the IMF's actual record and motives. For many of those critical of Malaysian government policy (not just in response to the crisis), IMF intervention is expected to put an end to all or at least much they consider wrong or wish to be rid off. In the wake of the protracted wrangling between the IMF and Suharto's government in Indonesia, this pro-IMF lobby sees the IMF as the only force capable of bringing about desirable reforms which domestic forces alone cannot bring about. Ironically, most of them fail to recognise that the contractionary measures[1] introduced since December 1997 and elaborated in March 1998 have been precisely what the IMF would like to see. Such measures have transformed the financial crisis into a more general economic crisis for the country.

The currency and financial crises have also contributed to new macroeconomic problems besides undermining economic development efforts more generally:

—with the massive ringgit devaluation, imported inflation is inevitable, especially for Malaysia's very open economy, whose gross exports are equivalent to over 80% of what it produces; it only imports slightly less, but the high import content of many manufactured exports exaggerates these measures of openness;
—over-zealous efforts to check inflation in these circumstances could exacerbate deflationary tendencies;
—business failures, growing unemployment and reduced incomes will exacerbate deflationary tendencies;
—the stock market collapse (by more than half since its peak in the first quarter of 1997) is bound to affect adversely both consumption and investment ('wealth effect');
—credit restraint policies adopted by the government since December 1997 will further dampen economic activity;
—the flight of foreign funds cannot be easily replaced by domestic funds which would have to be diverted from alternative uses;
—difficulties in recovering loans will further constrain the financial system and economic activity;
—the depreciated ringgit has increased the relative magnitude of the foreign debt as well as the external debt-servicing burden;
—despite the massive ringgit devaluation, there has not been a commensurate export boom for many reasons including: greater uncertainty and reduced confidence in the Malaysian investment environment; a limited price competitive effect owing to other devaluations in the region; greater uncertainty about foreign demand owing to international economic uncertainties; reduced commodity (especially petroleum) prices; reduced agricultural output due to climatic (El Niño drought) and environmental (haze) factors; lag time needed for new investments to begin production;
—technological progress is likely to slow down because of the greater costs of foreign technology acquisitions, as well as the greater attraction of falling back on cheap labour and production costs instead of making the human resource investments to achieve higher productivity.

[1] After tightening bank credit from December 1997, the financing of special funds for investment in food production and for small and medium industries (SMIs) as well as for car purchases (especially for the 'national cars') was increased. Nevertheless, the severe contractionary consequences of tighter liquidity have continued to slow down the economy fairly indiscriminately.

Conclusion

The Malaysian currency and financial crises since mid-1997 can be traced to financial liberalisation and its consequent undermining of national monetary and financial governance. The ringgit's virtual peg to the US dollar facilitated huge foreign capital inflows, which were necessary to cover the current-account deficit, exacerbated by the peg. Thus, foreign savings supplemented the already high domestic savings rate (40% in 1996) to raise the investment rate to 45%. This contributed to an asset price inflationary bubble involving shares and property.

As elsewhere in the region, besides encouraging portfolio investments as well as bank borrowings from abroad, the quasi-peg also became a target for currency speculators, as regional currencies appreciated with the US dollar despite its adverse consequences for export competitiveness and growth. Meanwhile, financial liberalisation had also created lucrative opportunities for taking advantage of falling, once over-valued currencies, thus accelerating and exacerbating the collapse of the region's currencies and share markets. All this, together with injudicious official responses in Malaysia, transformed the inevitable 'correction' of the overvalued ringgit into a collapse of both the ringgit and the Kuala Lumpur stock market as panic set in, made worse by 'herd' behaviour and 'contagion'. Government efforts to 'bail out' politically influential business interests and otherwise to protect or advance such interests—usually at the expense of the public (the public purse, workers' forced savings, taxpayers or minority shareholders)—have exacerbated the crisis in Malaysia by undermining public and foreign confidence.

To make matters worse, the 1998 Commonwealth Games and Asia Pacific Economic Cooperation (APEC) summit in Kuala Lumpur and various government efforts to prop up the property market, especially its residential component, may only serve to delay its apparently inevitable collapse. Given the heavy exposure of so many companies to the sector, especially among the KLCI's top 100 counters, this could drag out the crisis in the country much longer than in neighbouring countries, where property markets have already collapsed.

Yet, in other respects, Malaysia is relatively better off than its neighbours also affected by the crisis. Although prudential regulation had been weakened in recent years by various changes, especially those relating to financial liberalisation, it has remained better than in most other countries in the region besides Singapore and, possibly, the Philippines, thus saving Malaysia from some of the worst excesses witnessed elsewhere in the region. Lower domestic interest rates also limited the extent of foreign borrowings, most of which was hedged, owing to the relatively lower costs of hedging in Malaysia.

Despite various weaknesses, this Malaysian brand of ersatz capitalism—involving changing relations and institutions of 'crony rentierism'—sustained rapid growth for four decades since independence in 1957 (Gomez and Jomo, 1997). It has come unstuck owing to the economic consequences of and policy reactions to massive currency devaluation and asset price deflation due to 'irrational' herd behaviour greatly exaggerating the impact of 'rational' (i.e., rent-seeking) speculative market behaviour to gain advantage from the region's unsustainable currency appreciations. The overvalued ringgit and other regional currencies emerged in the mid-1990s owing to some unintended consequences of partial financial liberalisation,[1] which also created the conditions for the asset price inflationary bubble that has now burst with devastating consequences for the region.

[1] Full liberalisation would not have approved of the currency peg desired by the dominant financial interests.

In Malaysia, the gravity of the crisis and the difficulties of recovery have been exacerbated by injudicious policy responses, compromised by nepotism and other types of cronyism, though there is little persuasive evidence that cronyism in itself led to or precipitated the crisis. Failure to recognise the nature of the processes of accumulation and growth prevented the design and implementation of an adequate proactive strategy of well-sequenced liberalisation in the face of pressure from international financial interests. Fortunately, Malaysian central bank regulation and managed consolidation of the banking sector helped ensure its greater robustness compared to its neighbours, though the new restructuring attempted in the wake of the crisis is less well conceived and less likely to serve its intended ends. The authorities' push for the very rapid merger of banks and financial companies has been made particularly difficult by the uncertainties of such turbulent times and has a limited chance of success, especially in light of the recent failure of a similar Thai attempt. While the consolidation of the financial sector may be desirable to achieve economies and other advantages of scale in anticipation of further financial liberalisation, the acceleration of its pace in response to the crisis seems to be less well conceived.

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Appendix Tables

Table A.1. *Malaysia: key macroeconomic variables, 1989–96 (percentages)*

	1989	1990	1991	1992	1993	1994	1995	1996
GDP growth rate	9·2	9·7	8·7	8·0	9·0	9·1	10·1	8·8
Share of GDP								
Gross national savings	29·0	29·1	28·4	31·3	33·0	34·0	34·7	36·0
Consumption expenditure	65·2	66·6	66·5	63·5	62·3	61·2	60·5	58·1
Private	50·8	52·6	52·6	50·5	49·2	48·6	47·9	46·9
Public	14·4	14·0	13·9	13·0	13·1	12·6	12·6	11·2
Gross capital formation	29·3	32·4	36·4	36·0	38·3	40·1	43·0	41·8
Private	18·5	20·9	25·9	24·8	26·7	27·2	30·5	29·2
Public	10·8	11·5	10·5	11·2	11·7	13·0	12·6	12·6
Balance of payments								
Current account	–0·7	–2·1	–8·8	–3·8	–4·8	–6·3	–8·5	–5·2
Official long-term capital	–2·4	–2·5	–0·5	–1·9	0·6	0·3	2·7	0·3
Private long-term capital	4·4	5·5	8·3	8·9	7·8	6·0	4·7	4·5
Long-term capital, net	2·0	3·0	7·8	7·0	8·4	6·2	7·4	4·8
Basic balance	2·7	0·9	–1·0	3·2	3·6	–0·1	–1·1	–0·4
Private capital: net	1·5	1·2	3·9	8·0	8·4	–4·5	1·1	4·5
Private capital: commercial Banks	1·1	2·0	2·7	6·2	6·6	–7·0	0·1	3·4
Private capital: others private	0·4	–0·8	1·2	1·8	1·8	2·5	1·0	1·1
Errors and omissions	–1·0	2·6	–0·3	0·1	5·7	0·2	–2·0	–1·6
Overall balance	3·2	4·6	2·6	11·3	17·7	–4·3	–2·0	2·5
Implicit capital inflows	3·9	6·8	11·4	15·1	22·5	2·0	6·5	7·7
Short-term capital inflows	1·9	3·8	3·6	8·1	14·1	–4·2	–0·9	2·9

Source: Montes (1998).

Table A.2. *Malaysian ringgit exchange rates with US dollar and Japanese yen, 1984–98 (annual/monthly averages)*

Year/month	RM equivalent for one unit of US$	¥
1984	2·34	0·0099
1985	2·48	0·0105
1986	2·58	0·0154
1987	2·52	0·0175
1988	2·62	0·0204
1989	2·71	0·0197
1990	2·70	0·0188
1991	2·75	0·0205
1992	2·55	0·0201
1993	2·57	0·0232
1994	2·62	0·0257
1995	2·51	0·0268
1996	2·52	0·0231
1997	2·81	0·0232
June 1997	2·52	0·0202
July 1997	2·57	0·0223
Aug. 1997	2·75	0·0233
Sept. 1997	3·01	0·0249
Oct. 1997	3·29	0·0271
Nov. 1997	3·39	0·0271
Dec. 1997	3·77	0·0291
Jan. 1998	4·40	0·0338
Feb. 1998	3·82	0·0304

Source: Bank Negara Malaysia.

Table A.3. *Malaysia: economic growth, inflation, unemployment and interest rates, 1984–97 (percentages)*

Year/month	Growth	Inflation (CPI)	Unemployment	Fixed deposit interest rate
1984	7·8	3·6	6·3	10·5
1985	–1·1	0·4	7·6	7·3
1986	1·2	0·6	8·7	6·3
1987	5·4	0·8	8·2	2·5
1988	8·9	2·5	8·1	3·3
1989	9·2	3·9	7·5	5·0
1990	9·7	2·0	5·1	7·0
1991	8·7	4·4	4·3	8·0
1992	7·8	4·7	3·7	7·9
1993	8·3	3·5	3·0	6·5
1994	8·5	5·0	2·9	5·3
1995	8·8	3·5	2·8	6·6
1996	8·7	3·4	2·8	7·18
Jan. 97		3·2		7·26
Feb. 97		3·1		7·25
Mar. 97		3·2		7·25
Apr. 97		2·6		7·26
May 97		2·5		7·30
June 97		2·2		7·38
Jul. 97		2·1		7·52
Aug. 97		2·4		7·56
Sept. 97		2·3		7·63
Oct. 97		2·7		8·54
Nov. 97		2·6		9·11
Dec. 97		2·9		9·31
Jan. 98		3·4		9·34
Feb. 98		4·4		9·55
Mar. 98		5·1		9·81

Source: Bank Negara Malaysia; thanks to Mohd Aslam.